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ESG Day

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I am currently writing this letter in Europe, where virtually every other conversation is about one facet or another of environmental, social and governance (ESG) investing. It has gotten to feel a bit like the movie "Groundhog Day," in which the Bill Murray TV reporter character keeps pressing his alarm each morning, only to find himself re-enacting the same schedule over and over and over … *So, tell me about your firm's approach to ESG?* … *Great to see you, Andrew, what do you chaps have cooking on ESG?* … *Enchanté, ESG…*

I have no issue with the substance of ESG as a legitimate area of client interest, and not just in Europe. With some of the world's biggest consultants having announced that they will score every manager on its ESG capabilities alongside the rest of its research, increasingly nothing less than subscribing to a strong commitment in this area is enough to keep the dialogue going. Still, at the risk of being typecast as a cynic in just my second client letter, I would like to offer a different perspective: three rules that can actually move the discussion forward and allow all constituents to make more informed decisions.

Rule No. 1: Facts Are the Facts

My first principle is to suggest that **it is incredibly important to separate facts and opinions in this area**. While we may have become inured to how much the line between facts and opinions has blurred in political discourse, in investing it remains essential to distinguish between the two. At QMA, we go out of our way to create forums where different opinions can be debated by our entire investment team. We think this process ultimately sharpens our hypotheses and produces the best decisions. However, those decisions are then tested objectively by our research and the market, and the outcome is unambiguous. So, for example, you may believe that future bond returns will be higher than future equity returns, but that is clearly an opinion. The facts are that historically over the great majority of periods, equities offer higher returns than bonds. So your opinion would therefore have to rest on an argument that this time it's different, and then the market will judge whether your opinion is right via the returns that it delivers.

As part of our research work on ESG, we felt it was important to offer clients perspective on what ESG strategies have delivered historically. Since this is a widely researched and debated topic, we believed the right scientific approach was to make the assessment via a meta study analyzing the collective conclusions of the overall body of research in this space, rather than cherry-picking the one or two studies that suit a particular argument.

For those interested in the full paper incorporating this meta analysis, here is the link, but the three-second version is as follows: Studies have conclusively shown that companies that score better on ESG enjoy lower costs of capital, both debt and equity, and higher valuations than companies that score poorly on ESG. However, as yet, no definitive evidence exists based on the past 30-some years of data that investing in such companies produces higher returns (or lower returns for that matter).

Now, none of this precludes an argument that, for example, investing in companies that produce outsize carbon emissions will hurt *future* returns. It may well be that society imposes future taxes on such companies that change the nature of their business, or are not presently reflected in their valuations, so their emissions can definitely be argued to be an incremental risk they bear. (Indeed, although I caution that I am certainly no ERISA lawyer, I can personally see this as a reasonable risk for a fiduciary to consider as well.) However, this is also demonstrably an opinion, not a fact, and should be debated as such before being accepted.

Rule No. 2: Remember Whose Money It Is

My second principle is to recognize that **the money is the client's not the manager's, and that the spectrum of client demand is much more nuanced than the debate seems to acknowledge**. At one end of the spectrum you find clients for whom it is an intrinsic part of their mission, whether implicitly or explicitly, to avoid certain stocks or sectors with very hard ESG exclusions. At the other are many clients who would object strongly to anything other than return maximization considerations coming into play. However, there are also clients who – following the argument above about the risk attached to carbon emitters – don't want to exclude such companies outright but might want the manager to require that the prospective return from such companies be higher than normal to justify an investment given the additional risks involved. It is surely incumbent on us as an industry not to force our clients to one or the other end of the spectrum, but rather to find ways of responding to their different needs.

Rule No. 3: Be Transparent

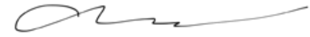
My final principle relates to the manager part of our ecosystem, and it is that **managers should be completely transparent with their clients about how ESG factors are impacting their judgments on both individual companies and on portfolio construction in aggregate**. Given the bandwagon-loving nature of our industry that I have remarked on before, it is no surprise to find that virtually all managers have hitched themselves to ESG in one way or another, if only as a defense mechanism in response to the volume of questions and interest we are all receiving. Among the scrum are certainly "evangelicals" for whom particular ESG analyses and beliefs are integral to the manager's investment philosophy, and that's great: clients can make informed judgments if that style is what they want. However, a great many others are finding that a very functional response when asked is to say something along the lines, "Of course we consider ESG factors as an integral part of our research agenda." But the danger is that this is just lip service – what the journalists here in Europe put under the lovely category of "greenwashing."

Aside from the danger that this sort of answer just further undermines client trust in our industry, it seems to be highly ill-suited to matching the different needs of clients. If a manager cannot be transparent with a client around exactly how it is treating the risk of carbon emissions, for example, then how can the manager meet the needs of both the client who cares about emissions as a risk factor and the one who doesn't?

Moreover, it is in every investor's interest to encourage investee companies to publish more hard data on their performance on the different ESG criteria; more data allows us all to make more informed choices. But if we as an industry try and fudge our own stance, how can we object if the companies in which we invest do the same?

To both accommodate the different types of client demand, and then help those clients match themselves to the most suitable managers, we as an industry need to offer full transparency and stop talking out of both sides of our mouths.

In conclusion, I have no doubt that increased client appetite for ESG investing is not a blip but rather a secular shift that will continue to grow on a global basis. As it matures, I believe this increased ESG demand will develop more nuances along the way. I would argue that, for both clients and managers, it's important to base ESG's growth on secure foundations so that clients with different beliefs and needs can have those needs properly met. Let us all have the courage to be transparent about our own approaches, and we will both help our clients make better choices and encourage investee companies down the same path.



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